BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
SEARS, ROEBUCK AND CO., ET AL.)

Appearances:

For Appellant; John H. Hall
Attorney at Law

Milton J. Kolb
Attorney at Law
Manager of Appellant! s
Income Tax Section

For Respondent: Jack E. Gordon
Counsel

O P I N I O N

This appeal is made pursuant to section 26077 of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the claims of Sears, Roebuck and Co., et al., for refund of franchise tax in the amounts of $129,105.60, $156,081.38 and $117,192.30 for the income years ended January 31, 1960, 1961 and 1962, respectively.

Sears, Roebuck and Co. (hereafter referred to as appellant) is a New York corporation with its principal place of business in Chicago, Illinois. It engages in the sale of, genera-1 merchandise throughout the United States. For California franchise tax purposes appellant files combined returns with several affiliated corporations.

A substantial number of appellant's sales are made on credit, under installment contracts or revolving charge accounts. A customer purchasing goods under one of those deferred payment plans is charged an amount in addition to the cash sale price, The additional fee which

is imposed as an incident of the credit sale is designated by appellant as a "service charge", "carrying charge" or "time price differential" . (Hereafter all such charges will be referred to collectively as carrying charges.) During the income years in question appellant 's carrying charge income, earned and accrued, was as follows: a

Income Ye	Carrying Charges
January 31, 1960	$177,522,629
January 31, 1961	196,682,262
January 31, 1962	206,874,904

None of this carrying charge income was reported as interest income for federal tax purposes. The question presented by this appeal is whether all or any part of that carrying charge income constituted "interest income subject to allocation by formula" within the meaning of section 24344, subdivision (b), of the Revenue and Taxation Code.

Because appellant derived income from sources within California. and elsewhere, it used formula allocation to determine the portion of its unitary income which was subject to tax in California. (Rev. & Tax. Code, § 25101.) This brought into operation section 24344, subdivision (b), of the Revenue and Taxation Code, which limited the interest expense deduction. available to appellant as follows:

> If income of the taxpayer is determined by the allocation formula contained in Section 25101, the interest deductible shall be an amount equal to interest income subject to allocation by formula, plus the amount, if any, by which the balance of interest expense exceeds interest and dividend income . . . not subject to allocation by formula. Interest expense not included in the preceding sentence shall be directly offset against interest and dividend income ... not subject to allocation by formula..

In the income years on appeal appellant received nonunitary interest and dividend income in the following amounts:

Income Year Ended	Nonunitary Interest and Dividend Income
January 31, 1960	$22,828,187.36
January 31, 1961	22,901,772.32
January 31, 1962	21,919,012.08

Because this interest and dividend income was income from intangible personal property which was not subject to allocation by formula, it was specifically allocated to the State of Illinois, appellant's commercial domicile. During those same years appellant earned interest income from investments which was subject to formula allocation, and it incurred or accrued interest expense as follows:

Income Year Ended	Unitary Interest Income	Interest Expense
January 31, 1961	$1,845,529.11	$25,289,023.80
January 31, 1962	-0-	17,259,116.33

In computing its apportionable income for California franchise tax purposes, appellant deducted the entire amount of interest expense which it had incurred or accrued in each of the income years on appeal. Of the total interest expense claimed as deductions respondent disallowed $19,104,352.43, $22,901,772.32 and $17,259,116.33 for the income years ended January 31, 1960, 1961. and 1962, respectively. Appellant paid the resulting proposed additional assessments and filed claims for refund, the denial of which gave rise to this appeal.

Respondent's disallowance of the major portion of the interest expense deduction claimed by appellant in each year rested upon a determination that although appellant's carrying charge income constituted unitary business income, it was not "interest income subject to allocation by formula" (emphasis added) as that phrase is used in section 24344, subdivision (b), of the Revenue and Taxation Code. Respondent would characterize the carrying charges in question as additional consideration by customers for the privilege of buying goods or services on a deferred payment basis, rather than as interest.

For tax purposes, interest has been defined by the Supreme Court of the United States as the amount one

has contracted to pay for the use of borrowed money, and as the compensation paid for the use or forbearance of money. (See Old Colony Railroad Co. v. Commissioner, 284 U.S. 552 [76 L. Ed. 484]; Deputy v. du Pont, 308 U.S. 488 [84 L. Ed. 416].) Section 1915 of the Civil Code of California, enacted in 1872, contains a similar definition of interest. The majority of federal tax cases discussing the meaning of the term "interest" have arisen under the provisions allowing the deduction of all interest paid or accrued within the taxable year on indebtedness. (Int. Rev. Code of 1954, § 163(a); Int. Rev. Code of 1939, § 23(b).) In the absence of a statutory provision to the contrary, however, the same rules should govern in determining whether interest constitutes income to the seller as are used to determine whether interest is deductible by the purchaser. (Estate of Betty Berry, 43 T.C. 723, 731, aff'd, 372 F.2d 476.)

Prior to the enactment of the Internal Revenue Code of 1954 it was held that where property was sold on a deferred payment basis, and the contract of sale did not specifically provide that a part of the deferred payment was interest, no part of that payment was deductible as interest, (Daniel Brothers Co., 7 B.T.A. 1086, aff'd, 28 F.2d 761; Elliott Paint & Varnish Co., 44 B.T.A. 241; Marsh & Marsh, Inc., 5 B.T.A. 902.) Carrying charges were construed as amounts imposed in addition to the cash selling price essentially to defray the expense of handling installment sales (Weyand Furniture Co., T.C. Memo., Aug. 30, 1951), and no part of such a charge was deductible as interest unless the interest portion was stated as a separate part of the total finance charge. (Louise Ross, T.C. Memo., Dec. 29, 1964; Glenn H. Strother, T.C. Memo., June 25, 1957.) Respondent's regulations relating to the California Personal Income Tax Law contain a provision which is consistent with these holdings, stating:

> Furthermore, interest paid under installment contracts, cannot be deducted unless the actual interest charge can be determined. Thus, finance charges, service charges, and the like cannot be deducted if such charges are not stated separately. The use of any formula for determining such charges is not permitted. (Cal. Admin. Code, tit. 18, reg. 17203.)

Section 163(b) of the Internal Revenue Code of 1954 was enacted to give relief to the installment buyer

. who paid carrying charges but was allowed no interest deduction under prior law because interest was not separately stated. (Louise Ross, supra; Re v. Rul. 67-62, 1967-1 Cum. Bull. 44.) That section as enacted provided, in pertinent part:

> (1) . . . If personal property is purchased under a contract --
>
> (A) which provides that payment of part or all of the purchase price is to be made in installments, and
>
> (B) in which carrying charges are separately stated but the interest charge cannot be ascertained,
>
> then the payments made during the taxable year under the contract shall be treated for purposes of this section as i.f they included interest equal to 6 percent of the average unpaid balance under the contract during the taxable year.. ..

In 1961 the California Legislature enacted a similar provision in-the Personal Income Tax Law (Rev. & Tax. Code, § 17203, subd. (b)). It is to be noted that these-sections allow the deduction of a portion of an individual's installment payments as if those payments included the stated. percentage of interest. This is not a legislative declara-, tion that in fact such payments do include that amount of interest.

No similar provision exists in either California or federal law with respect to the treatment to be afforded carrying charge income received by the seller of goods on a deferred payment basis. In determining the nature of. such income in the instant case, therefore, we must disregard the relief provisions of section 163(b) of the Internal Revenue Code of 1954 and section 17203, subdivision (b), of the Revenue and Taxation Code, and rely on the law as it stood prior to the enactment of those sections.

Appellant first argues that the entire amount. of its carrying charge revenue constitutes interest income. In support of this contention appellant cites several United States Tax Court memorandum decisions in which the entire amount of carrying charges paid by the taxpayers in connection with installment purchases of household goods were held to be deductible as interest. (O. G. Russell, T. C. Memo., Nov. 6, 1953; Oliver W Bryant, T.C. Memo., May 2, 1952; Arthur S. McKenzie, T.C. Memo., May 2, 1952; Carl E. Noe, T.C. Memo., May 2, 1952.) The

same judge decided the Bryant, McKenzie and Noe cases, and each decision was based on his finding that the amounts designated as carrying charges did in fact constitute interest. The same determination was made by the court in the Russell. case. Thus those decisions are not inconsistent with the general rule prior to 1954 that interest paid on an installment contract was deductible if the amount of that interest could be ascertained.

There can be little doubt that appellant incurs substantial extra expenses as a result of the extension of credit to its many customers, expenses which would not be incurred if all sales' were on a cash basis. Such additional cost factors include the expense of maintaining individual files on all charge customers, credit investigation expenses, and billing and collection costs. Presumably a significant portion of the carrying charges imposed by appellantis intended to defray those legitimate additional costs. That being so, we must reject any suggestion that the carrying charges constitute interest in their entirety.

Appellant next would have us determine that at least some percentage of its carrying charge income should be treated as interest income for purposes of applying section 24344, subdivision (b), of the Revenue and Taxation Code. Appellant proposes several alternative rates' and methods of computation which might be used to determine the interest element, and contends that this is a proper dase for making'such an approximation.. Under any of the methods suggested, the resulting estimate of unitary. interest income would exceed appellant's interest expense during the years in question, making the entire amount of that interest expense deductible.

A'payment need not be termed "interest" to be so treated, if that is in fact what it amounts to. (L-R Heat Treating Co., 28 T.C. 894; Rev. Rul. 69-188, 1969-1 Cum. Bull. 54.) Nor is it necessary that interest be stated as a specific percentage of the sum loaned or computed at a rigid stated rate in order to be deductible. (Rev. Rul. 69-188, supra.) It is a prerequisite to deductibility, however, that the, sum claimed as interest be definitely ascertainable. (Kingsford , 41 T.C. 646; Kena, Inc., 44 B.T.A. 217.) If any part of appellant's carrying charge income constitutes interest as opposed to finance charges, the amount of the interest should be readily ascertainable. In spite of appellant's singular access to the records containing that information, no effort has been made to produce such figures. That being the case, we have no basis for any attempt at an approximation.

Upon review of the entire record we must conclude that appellant has failed to establish that all or any part of its carrying charge income represents "interest income subject to allocation by formula," within the meaning of section 24344, subdivision (b), of the Revenue and Taxation Code. Respondent's determination in this matter must therefore be sustained.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS REREBY'ORDERED, ADJUDGED AND DECREED, pursuant to section 26077 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the claims of Sears, Roebuck and Co., et al., for refund of franchise tax in the amounts of $129,105.60, $156,081.38 and $117,192.30 for the income years ended January 31, 1960, 1961 and 1962, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 4th day of June, 1970, by the State Board of Equalization.

_____, Chairman
_____, Member
_____, Member
_____, Member
_____, Member

ATTEST: _____, Secretary